No. 78-561

In the Supreme Court of the United States

OCTOBER TERM, 1978

UNITED STATES OF AMERICA, PETITIONER

v.

NEIL T. NAFTALIN

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

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There is no disagreement about the facts relevant to the question of statutory interpretation presented in this case. Respondent does not deny that, by falsely representing that he owned the stock that he sold, he defrauded the brokers who executed his sales (Br. 7-8, 11), and he does not dispute that the brokers suffered financial injury as a result of his fraudulent scheme (Br. 10, 12).

Respondent correctly points out that the brokers initially covered his short sales with borrowed securities (Br. 9). Under SEC Rule 10a-2, 17 C.F.R. 240.10a-2, a seller's broker may make delivery on the settlement date with borrowed securities if he is informed that the securities are in transit to him or will be forwarded by the seller without undue delay. See II L. Loss, *Securities Regulation* 1233 (1961 ed.); see also New York Stock Exchange Rule

440B.17, 2 CCH New York Stock Exchange Guide para. 2440B.17. But as soon as the broker learns that his customer is unable to make delivery, he must "buy in" the shares. *Ibid.*[1] That is precisely what occurred here. Respondent's brokers covered his position with borrowed securities and bought in when they learned that he was short. Respondent does not quarrel with the proposition that this covering process served to insure investors against his failure to deliver.[2] He argues, however, that this insurance device insulated him from criminal liability under Section 17(a)(1) for his fraud.

I

Respondent argues that Section 17(a)(1) does not extend to the fraud that he admittedly practiced because he injured broker-agents rather than purchasers (Br. 17-19). He contends that a fraud cannot occur "in" a sale or offer unless it injures a purchaser. But respondent's frauds occurred "in" sales even if their harmful effects did

[1]If the broker has not previously forwarded borrowed securities, the securities that he "buys in" must be sent to the purchaser's broker.

[2]That is not to say that respondent's scheme did not expose investors to additional risk. See pages 23-27 of our opening brief. Had respondent's brokers been unable to cover, a "fail to deliver" would have resulted. In December 1968 "fails to deliver" of New York Stock Exchange member firms, resulting from various causes, exceeded $4 billion worth of securities. See *Clearance and Settlement of Securities Transactions: Hearings on S. 3412, etc. Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 92d Cong., 2d Sess. 94-96 (1972). Prior to the establishment of the Securities Investor Protection Corporation in 1970 (see 15 U.S.C. 78aaa *et seq.*), purchasers were exposed to the risk that they would not receive their shares if brokers became insolvent and were unable to cover outstanding sales. See *Securities Investor Protection Corp.* v. *Barbour*, 421 U.S. 412, 415 (1975). See also SEC *Report of Special Study of Securities Markets*, H. R. Doc. No. 95, Pt. 1, 88th Cong., 1st Sess. 418 (1963); *Bradford National Clearing Corp.* v. *SEC*, No. 77-1119 (D.C. Cir. Sept. 19, 1978), slip op. 4-5.

not reach investors. As respondent admits, he committed deception through communications of the following nature: "Sell long 1,000 Burroughs at market for Naftalin & Company" (Br. 8). His company was not "long" in this security when he made the statement (Br. 7). In these circumstances, the ordinary meaning of the words of the statute compel the conclusion that a misrepresentation occurred "in" respondent's sale. He ordered brokers to sell and committed fraud in the process.

The statute prohibits the use of all schemes to defraud in a sale or offer of a security. The term "sale" includes "every * * * disposition * * * of a security * * * for value." 15 U.S.C. 77b(3). Where, as here, a customer deceives a broker in the process of disposing of a security, the statute has been violated. If there were any doubt about the coverage of the statute, the definition of "offer" would remove it: "offer" embraces "every attempt * * * to dispose of * * * a security * * * for value." An order to a broker to sell securities is an attempt to dispose of them, and, without more, is an offer within the meaning of the statute. If the customer practices deception in placing the order, fraud occurs in an offer, in violation of the statute.[3]

The fact that brokers serve as agents does not alter the fact that they participate in sales and offers. As the district court pointed out, there is "privity" of dealing between a seller and his broker (A. 25). The broker acts for the seller in disposing of the shares; the seller acts through his broker. It should make little difference, in determining whether a fraud occurs "in" an offer or sale, whether the seller bilks the broker or the buyer. In sales through brokers, the broker has

[3]The indictment charged respondent with fraud in securities offers, as well as sales, and the district court specifically found that "[a]s to each count of the indictment * * * the defendant acted as charged" (Pet. App. 20a). Respondent is therefore mistaken in contending (Br. 18 n.31) that the district court "found only fraud in the 'sale' of securities."

an active role. He receives and executes sell orders and confirms the transactions in written communications to the seller. See 17 C.F.R. 240.10b-10; Model U.C.C. §8-319(a), (c) (1972 ed.). The seller satisfies his delivery obligation by presenting securities to the broker (Model U.C.C. §8-314), and the broker must make payment after tender of the securities on the settlement date. Moreover, under the SEC's covering rules, the seller's broker, obliged to make delivery to the purchaser's broker if the seller fails to deliver, sustains many of the risks of the trading process. In these circumstances, it is difficult to understand the argument that fraud practiced by customers on brokers during the selling process does not occur "in" an offer or sale.

II

Respondent asserts (Br. 19-22) that because Section 17(a)(3) of the Act is limited to fraud that operates on purchasers, this limitation should be read into Section 17(a)(1). The short answer to that contention is that Congress has written the law differently. Section 17(a) proscribes three categories of misconduct, and each subsection has its own coverage.[4] Subsection (3) forbids practices that defraud purchasers. Subsection (1), in contrast, forbids all fraudulent devices, without limitation on the class of victims. There is no justification for applying the purchaser limitation under subsection (1), where it has been omitted. As the district court pointed out (A. 25):

[4]Respondent asserts that if the three subsections of Section 17(a) had not been separately enumerated, and the expression "fraud * * * upon * * * the purchaser" had been made applicable to each subsection, the statute, "with minor grammatical corrections," would read as it "should" read (Br. 20). This line of argument appears to concede that the statute, as actually written by Congress, will not support the interpretation offered by respondent.

> Reading §17(a) literally, only subdivision (3) requires that the defrauded party be a purchaser. The acts specified in each subdivision are separate and distinct; each is an "allowable unit of prosecution."

See also *United States* v. *Birrell*, 266 F. Supp. 539, 543 (S.D.N.Y. 1967).

This Court's decision in *United States* v. *Gilliland*, 312 U.S. 86, 93 (1941), establishes that general antifraud provisions should not be read narrowly merely because more limited antifraud provisions also are contained in the statute. *Gilliland* involved a prosecution under a provision of the Criminal Code (52 Stat. 197) that prohibited any person to "falsify or conceal or cover up by any trick, scheme, or device a material fact, or make or cause to be made any false or fraudulent statements" in reports filed with government agencies. The provision also prohibited the submission of any bill or voucher falsely claiming money from the government. The defendant in *Gilliland* contended that the general prohibition should be limited to the subject matter of the narrower prohibition, and that the statute should be confined to cases involving pecuniary injury to the government. This Court rejected the proposed application of the doctrine of ejusdem generis, explaining:

> The rule of *ejusdem generis* is a familiar and useful one in interpreting words by the association in which they are found, but it gives no warrant for narrowing alternative provisions which the legislature has adopted with the purpose of affording added safeguards.

Id. at 93. See also *United States* v. *Alpers*, 338 U.S. 680, 682-684 (1950), pointing out that the doctrine of ejusdem generis cannot be used to render general provisions meaningless, especially where the legislature has intended to adopt a "comprehensive" remedial statute. There can be no doubt that the antifraud provisions of the securities laws were

intended to serve broad remedial purposes (see page 21 of our opening brief) and respondent's restrictive interpretation would frustrate those purposes.[5]

III

Respondent refers to legislative history showing that Congress intended to protect investors when it enacted the Securities Act of 1933 (Br. 22-26), and asks the Court to infer that this was the sole purpose. But respondent has not found a single piece of legislative history that suggests that investor protection was the exclusive purpose, or that Congress was not concerned with frauds causing injury to business.[6] The legislative history shows beyond genuine

[5]Of course, rules of construction such as ejusdem generis ("of the same kind") or noscitur a sociis ("known by association") may bear on the question whether a term in a statute qualifies or limits preceding terms. But rules of construction must always be used to implement the purpose of the statute and the intention of the legislature. See, *e.g.*, *Porto Rico Ry.* v. *Mor*, 253 U.S. 345 (1920); *FMC* v. *Seatrain Lines, Inc.*, 411 U.S. 726 (1973). Such rules "long have been subordinated to the doctrine that courts will construe the details of an act in conformity with its dominating general purpose * * *." *SEC* v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344, 350-351 (1943). They may not be applied to distort a statute. See *Costanzo* v. *Tillinghast*, 287 U.S. 341, 344 (1932) ("since the phrase [in question] has a proper office in qualification of the class specified in the clause in which it appears, its effect should be limited to that class and not carried over to the others").

[6]The cases relied on by respondent are as unhelpful to him as is the legislative history. It is true that both *United States* v. *Ashdown*, 509 F. 2d 793 (5th Cir. 1975), and *United States* v. *Schaefer*, 299 F. 2d 625 (7th Cir. 1962), state that in prosecutions under Section 17(a) the government must show an "impact" on investors arising from the use of the mails. But these courts did not use the term "impact" as the equivalent of "financial loss." In those cases, there was no question that investors had suffered losses; the issue was "whether the mailings were sufficiently related to the scheme to provide a federal jurisdictional base." *Ashdown, supra*, 509 F. 2d at 798; see also *Schaefer, supra*, 299 F. 2d at 629-630. In both cases the courts held that the government met its burden when it proved that the use of the mail was more than incidentally related to the fraudulent scheme. Neither court addressed the question whether Section 17(a) would be violated if someone other than an investor suffered injury.

question that Congress adopted the Securities Act of 1933 as part of the national effort to correct abuses that contributed to the collapse of the economy during the Depression. Congress believed that honesty in securities transactions would help to restore economic health by protecting the interests of both investors and businesses. See S. Rep. No. 47, 73d Cong., 1st Sess. 1 (1933); H.R. Rep. No. 85, 73d Cong., 1st Sess. 2-3 (1933).[7] Because Congress intended to protect the national economy by prohibiting all forms of fraud in securities offers and sales, the legislative history provides no basis for adopting the narrow construction urged by respondent.[8]

Respondent also argues that the 1933 Act was "preoccupied with the regulation of public offerings of securities" and was not directed to trading in securities in the "aftermarket" (Br. 23). The Securities Exchange Act of 1934, of course, provides pervasive regulation of transactions in the aftermarket. But Section 17(a) of the Securities Act of 1933 also governs such trading. That Section extends to any fraudulent scheme in an offer or sale of securities, not just to schemes occurring in primary distributions. As the House Report points out, the 1933 Act

[7]There is nothing "isolated" or "oblique" (Br. 25) about these references to business injury. See Pet. Br. 16-21.

[8]The law review article cited by respondent (Br. 25), Herlands, *Criminal Law Aspects of the Securities Act of 1933*, 67 U.S. L. Rev. 562, 571 (1933), points out that Section 17(a) "adopts almost verbatim the language of the mail fraud statute." That statute (18 U.S.C. 1341) forbids all fraudulent schemes practiced through the mails. See, *e.g.*, *United States* v. *Netterville*, 553 F. 2d 903, 909 (5th Cir. 1977), cert. denied, 434 U.S. 1009 (1978); *United States* v. *Serlin*, 538 F. 2d 737, 744 (7th Cir. 1976). See also *Durland* v. *United States*, 161 U.S. 306, 313-314 (1896). There is no limitation on the class of victims under the mail fraud statute, just as there is no limitation under Section 17(a)(1). The object of both statutes is to prohibit fraud in the regulated medium—in the one case, the mails; in the other, offers and sales of securities.

prohibits "any device, scheme, or artifice to defraud, employed in connection with the sale in interstate or foreign commerce of any securities, *whether new or already outstanding*." H.R. Rep No. 85, *supra*, at 6 (emphasis added). This Court has observed that Section 17(a) applies to insider trading activities in the aftermarket. See *Foremost-McKesson* v. *Provident Securities Co.*, 423 U.S. 232, 255 (1976). And it clearly applies to broker-dealer transactions in the aftermarket. See III Loss, *supra*, at 1428. See also *Charles Hughes & Co.* v. *SEC*, 139 F. 2d 434, 435-438 (2d Cir. 1943); *Mawod & Co.* v. *SEC*, No. 77-1495 (10th Cir. Jan. 24, 1979).

IV

Respondent finally contends (Br. 26-32) that Section 17(a)(1) is inapplicable here because short selling is regulated by Section 10(a), and fraud in connection with a purchase or sale of a security by Section 10(b), of the Securities Exchange Act of 1934, 15 U.S.C. 78j. But the indictment charges respondent with fraud in the offer and sale of securities, which is precisely what Section 17(a)(1) prohibits. The government properly relied on Section 17(a)(1) to reach fraud in both an *offer* and sale because, in that respect, Section 17(a) reads more broadly than Section 10(b) (*Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 733-734 (1975)). Because, moreover, the substance of the charge was fraud, and not simply failure to comply with rules regulating short selling, the government was not required to proceed under Section 10(a).

The fact that respondent's conduct may have violated other provisions of the federal securities laws in addition to Section 17(a)(1) is not material. See *SEC* v. *National Securities, Inc.*, 393 U.S. 453, 468 (1969) ("the existence or nonexistence of regulation under §14 would not affect the scope of §10(b) * * *. The fact that there may well be some overlap is neither unusual nor unfortunate"). See also *Edwards* v. *United States*, 312 U.S. 473, 483-484

(1941), holding that both Section 17(a) and the federal mail fraud statute may properly be applied to fraudulent securities sales and noting that "[t]he two can exist and be useful, side by side." Accord, III Loss, *supra*, at 1428. As this Court has pointed out, "so long as the prosecutor has probable cause to believe that the accused committed an offense defined by statute, the decision whether or not to prosecute, and what charge to file or bring before a grand jury, generally rests entirely in his discretion." *Bordenkircher* v. *Hayes*, 434 U.S. 357, 364 (1978); see also *United States* v. *Beacon Brass Co.*, 344 U.S. 43, 45-46 (1952).[9]

For the foregoing reasons, and those set forth in our opening brief, the judgment of the court of appeals should be reversed.

Respectfully submitted.

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Solicitor General

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[9]The scope of the prosecutor's discretion to elect among applicable criminal law provisions in seeking an indictment is discussed in greater detail on pages 35-41 of our brief in *United States* v. *Batchelder*, No. 78-776, cert. granted (Jan. 8, 1979), a copy of which has been furnished to counsel for respondent.